B. AN HISTORICAL PERSPECTIVE OF SMALL ISSUE BONDS

by
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1. Introduction

Several good sources are available to teach the nuts and bolts of small issue bonds. Two are published by the National Association of Bond Lawyers. The Fundamentals of Municipal Bond Law and The Bond Attorneys' Workshop contain excellent chapters on small issue bonds. An excellent and comprehensive in-house source is Module G of the Tax Exempt Bond Phase I Training Course. The purpose of this article is not to merely restate a general discussion of the law. While this article's focus is to give the reader a better understanding of small issue bonds, it will not provide another overview of the subject. Rather, its intent is to provide an historical perspective of the subject matter. It will describe activities occurring in the bond market and will describe how these market activities fomented reactions by the Congress, the Treasury Department and the Internal Revenue Service.

Furthermore, this article will focus on the major legislative acts that affected small issue bonds. It will not cover every little change that occurred. It will, however, discuss major changes in the rules affecting small issue bonds. The goal, then, is to provide an understanding of the reasons behind the rules. It is hoped that a better understanding of this background will provide a better understanding of the application of the rules. This article will also discuss selected IRS rulings.

2. History of Industrial Development Bonds - Before 1968

The early history of small issue bonds is tied closely to the history of public financing of private business generally. Historically, financing of private business was a small scale activity, used to spark economic growth. This was viewed as a legitimate governmental concern. As the size of individual issuances increased and the scope of industrial development bonds became more pervasive, the Congress and the Treasury became concerned with the negative impact the financing of private business had on the tax exempt bond market. When the Congress did enact controls over the issuance of industrial development bonds, the small issue exception was added in the eleventh hour.

In the decades prior to enactment, only a few private rulings addressed the issuance of industrial development bonds. One letter approved an industrial development bond as early as 1936. As noted by the Senate Finance Committee on the *Tax Adjustment Act of 1968, Hearings on H.R. 15414 Before the Senate Committee on Finance, 90th Cong., 2nd Sess.,* industrial development financing was originally developed as a means of attracting small industry to low income and underemployed communities. Prior to the

1960s, these bonds were used primarily to finance small manufacturing firms in rural areas. However, the atmosphere did not generally favor this type of transaction until the 1950s. For example, Regulation 111, section 29.22(b)(4)-1, interpreting section 22(b)(4) of the Internal Revenue Code of 1939 (1939 Code), provided that if the issuance of special tax bills is legally collectible from [private] owners of the property benefited, they are not obligations of a State, Territory, or political subdivision. This provision was, in effect, broad enough to prevent issuance of industrial development bonds. However, this prohibition was removed from the regulations on December 28, 1951, leaving the door open for the issuance of such bonds. At this time, no published positions favored such bonds. However, favorable revenue rulings soon followed.

In 1954, the Service published Rev. Rul. 54-106, 1954-1 C.B. 28, interpreting section 22(b)(4) of the 1939 Code. This ruling provided that bonds issued by or on behalf of a municipality to finance acquisition or construction of municipally owned industrial plants for lease to private enterprises are obligations of a political subdivision within the meaning of section 22(b)(4) of the 1939 Code. Interest was tax exempt even though the bonds were issued for the benefit of private enterprises and the payment on the bonds was limited to revenues derived from the leases.

Rev. Rul. 57-187, 1957-1 C.B. 65, extended this same reasoning to local industrial development boards established pursuant to state law. Moreover, it applied this approach under the 1954 Code. Under these rulings, bonds may be issued to finance projects even though the sole basis for repayment of the bonds is limited to revenues from the projects.

This approach continued into the 1960s. In Rev. Rul. 63-20, 1963-1 C.B. 24, the Service addresses the issuance of bonds "on behalf of" a political subdivision. By this time, the Service accepted as ordinary, the issuance of industrial development bonds with payment limited to revenue from the private users.

However, over the next few years both the Congress and the Treasury had second thoughts about the wisdom of issuing industrial development bonds. The Treasury and the Service regarded the issuance of industrial development bonds as inconsistent with the Service's position against the issuance of arbitrage bonds. During hearings held by the Senate Finance Committee on the Tax Adjustment Act of 1968, *supra*, the Assistant Secretary of the Treasury, Stanley Surrey, stated that IRS rulings favoring industrial development bonds could not stand consistently with the Service’s position on arbitrage bonds. In both cases, the issuer acted as a conduit for an investment, taking no risk or responsibility for payment on the bonds.

Because communities acted as conduits for businesses, the credit of the corporation rather than the community provided the financial backing for the issuance. Thus, a community could borrow well beyond its own financial capacity. This is demonstrated in the following examples. One town of 30,000 inhabitants issued $140 million of tax exempt bonds to fund a major aluminum production plant. In another case, a town comprised of 35 voters, issued $20 million of bonds for a major corporation. See 113 Cong. Rec. 31614 (1967). Although the credit of a small town would normally limit the amount of bonds it could issue, this limitation is not present where the issuance is backed by the corporation. As more and more corporations took advantage of tax exempt financing, funding of large corporations flooded the municipal bond market. This practice threatened the existence of tax exempt financing. As pointed out in the Senate Committee on Finance Hearings, Assistant Secretary Stanley Surrey noted that about one-third of the total annual tax exempt issuances involved the use of industrial development bonds to fund businesses. The lion's share of these issuances was comprised of very large issuances for the benefit of large corporations. The end result of flooding the market with private funding was an increased cost to governments of funding traditional governmental projects such as roads and schools. Mr. Surrey stated that the cost of borrowing by government increased by one-half of one percent in 1967 alone and, if the issuance of industrial development bonds was left unchecked, the cost of tax exempt financing could approach that of taxable financing.

By March of 1968, both Congress and the Treasury were prepared to offer solutions to control the issuance of industrial development bonds. On March 6, 1968, Treasury released Technical Information Release 972 (TIR-972) which announced that the Treasury would issue regulations providing that industrial development bonds would no longer be considered obligations of a State or local government within the meaning of section 103(a) of 1954 Code. This release also announced that Treasury would no longer follow Rev. Rul. 54-106, Rev. Rul. 57-187, and Rev. Rul. 63-20 to the extent they provide direct or implied approval of industrial development bonds. On March 23, 1968, the Service published these proposed regulations in 33 Fed Reg. 4950 (1968).

In spite of Treasury's intent to ban all industrial development bonds in its proposed regulations, it appears that its ban may have been a holding action. In the hearings on H.R. 15414, Assistant Secretary Surrey noted that the subsidization of small businesses in rural areas was currently under study. Thus, notwithstanding the proposed ban on industrial development bonds, Treasury intended to retain a subsidy to assist poor rural communities in attracting attract small businesses.

The Senate Finance Committee held its hearings on H.R. 15414 on March 13 through 15 of 1968. The Committee reacted strongly and swiftly to TIR-972, amending the legislation before it to include a provision directing the Service to continue to issue private letter rulings in conformance with the above-mentioned revenue rulings. In addition, the Finance Committee proposed an amendment to exempt specific activities.

Generally, the Committee agreed with the Treasury and the Service with respect to the fact that something had to be done about industrial development bonds. The only apparent disagreement was who should do it. Ultimately, Congress prevailed, trumping the regulations. As the Finance Committee Hearings on H.R. 15414 demonstrate, there existed a strong intent among the Committee's members to retain the original purpose of industrial development bonds while controlling abuses. Clearly, the committee members believed the proper course was to correct through legislation rather than regulation.

The Conference Committee established the regime still followed today. It provided that industrial development bonds are generally taxable. See Conf. Rep. No. 1533, 90th Cong., 2nd Sess. (1968). However, facilities carrying on specified exempt activities would be excepted as operating for the public benefit. Prior to meetings of the Conference Committee, no mention had been made of small issue bonds. Without discussion, the conference agreement added a continuing exemption for issues of less than $1 million. The focus of the congressional debate with respect to this continuing exemption was to ensure that communities could attract small business without providing financing for large businesses. Initially, Congress set a $1 million limit in the Tax Adjustment Act of 1968, also referred to as Revenue and Expenditure Control Act of 1968, P.L. 90-364, 82 Stat. 266, I.R.C. § 103(c)(6). Within a few months it added the $5 million election in a rider to the Renegotiation Amendments Act of 1968, P.L. 90-634, as members of the Senate believed that the $1 million limit was unrealistic. See 114 Cong. Rec. 30603 (1968). The election was later raised to $10 million in 1978, *infra*.

3. Enactment of the Small Issue Provisions - 1968

The theme demonstrated in the initial enactment of the small issue provisions followed closely the concerns raised by the Congress, Treasury and the Service with respect to industrial development bonds. Its purpose was to provide a subsidy to enable communities to attract development of small businesses. In addition, the approach used by Congress controlled access to and use of the subsidy. A concurrent focus of the theme was to keep the subsidy away from large businesses. This dual purpose is demonstrated in subsequent rulings as well as later amendments to the Code.

The passage of the Revenue and Expenditure Control Act of 1968 and the Renegotiation Amendments Act of 1968 substantially changed the terrain with respect to public financing of private businesses. Under the enactment, I.R.C. § 103 provided generally that public financing of private business was held not tax exempt unless specifically excepted. It then set forth a two-prong approach controlling issuance of such bonds.

First, the Code provided for the tax exemption of specified activities including docks, residential real property, airports, solid waste disposal and pollution control facilities among others. This approach limits the funding to activities regarded as beneficial to the public in general while providing substantial control over the issuance of industrial development bonds generally. A discussion of exempt facility bonds is outside the purview of this article which is limited to small issue bonds.

The second prong limited the amount of the issuance. This is the small issue exemption under I.R.C. § 103(c)(6), which was later renumbered as § 103(b)(6). This section later moved to I.R.C. § 144(a) in the 1986 Code substantially intact. The small issue exemption provides rules with respect to two separate limitations, the $1 million limitation and the $5 million limitation (which was later raised to $10 million). The passage of I.R.C § 103(c)(6) presaged congressional intent to control how small issuances could be used.

The $1 million limitation, codified in I.R.C. § 103(b)(6)(A) through (C), provided the following:

> *(A) In General*. [The provision stating that industrial development bonds are not tax exempt under I.R.C. § 103] *shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less and substantially all the proceeds of which are to be used (i) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (ii) to redeem part or all of a prior issue which was issued for purposes described in clause (i) or this clause.*
>
> *(B) Certain prior issues taken into account. If--*
>
> *(i) the proceeds of two or more issues of obligations (whether or not the issuer of each such issue is the same) are or will be used primarily with respect to facilities located in the same incorporated municipality or located in the same county (but not in any incorporated municipality),*
>
> *(ii) the principal user of such facilities is or will be the same person or two or more related persons, and*
>
> *(iii) but for this subparagraph, subparagraph (A) would apply to each such issue,*
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> *then, for purposes of subparagraph (A), in determining the aggregate face amount of any later issue there shall be taken into account the face amount of obligations issued under all prior such issues and outstanding at the time of such later issue (not including as outstanding any obligation which is to be redeemed from the proceeds of the later issue).*
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> *(C) Related persons.-- For purposes of this paragraph and paragraph (7), a person is a related person to another person if-*

(i) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), or

(ii) such persons are members of the same controlled group of corporations (as defined in section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears therein).

The most significant parts of the $5 million limitation are provided in I.R.C. § 103(b)(6)(D) and (E) as follows:

(D) $5,000,000 limit in certain cases.-- At the election of the issuer, made at such time and in such manner as the Secretary or his delegate shall by regulations prescribe, with respect to any issue, this paragraph shall be applied--

(i) by substituting "$5,000,000" for "$1,000,000" in subparagraph (A), and

(ii) in determining the aggregate face amount of such issue, by taking into account not only the amount described in subparagraph (B), but also the aggregate amount of capital expenditures with respect to facilities described in subparagraph (E) paid or incurred during the 6-year period beginning 3 years before the date of such issue and ending 3 years after such date (and financed otherwise than out of the proceeds of outstanding issues to which subparagraph (A)applied), as if the aggregate amount of such capital expenditures constituted the face amount of a prior outstanding issue described in subparagraph (B).

(E) Facilities taken into account.-- For purposes of subparagraph (D)(ii), the facilities described in this subparagraph are facilities--

(i) located in the same incorporated municipality or located in the same county (but not in any incorporated municipality), and

(ii) the principal user of which is or will be the same person or two or more related persons.

For purposes of clause (i), the determination of whether or not facilities are located in the same governmental unit shall be made as of the date of issue of the issue in question.

The basic limitation was set by the threshold amounts of $1 million and $5 million. From the start, this limited the huge issuances prevalent in the period immediately before the passage of the legislation. The amount of the subsidy was further restricted by provisions which prevented the combination of issuances or limited the size of the operation receiving the subsidy.

The provisions, which are shaded above, operate to limit the amount and type of use of small issue bonds. These provisions include the following core elements with respect to aggregation of authorized issuances with a face amount of $1 million:

1. Acquisition, construction, reconstruction or improvement of land or property
2. Prior issues taken into account
3. Same municipality or county
4. Principal user
5. Related persons

In addition to the above provisions, the $5/$10 million election includes the aggregation of capital expenditures during a six-year period beginning three years before the date of issuance.

A. Development of New Businesses

Congress controlled the use of the funds by adding a use provision in which substantially all of the proceeds of the issuance must be used for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation. Congress intended that small issue bond financing would actually be used to create new business. Congress did not intend to provide tax exempt financing for working capital. Creation of new business continues to be the underlying theme of the small issue bond provisions. In the years that followed, Congress would strengthen this theme by limiting the use of tax exempt financing to purchase existing facilities or land.

B. The Aggregate Authorized Face Amount

The requirement to aggregate authorized face amounts of prior issues is applicable to $1 million small issues and small issues made under the $5 or $10 million election. In effect, the statutory requirement to aggregate operates to limit the size of the facilities that can be financed with qualified small issue bonds. The aggregation of prior bonds includes rules with respect to combining facilities and rules with respect to combining owners and users. These rules must be considered together. Thus, aggregation of prior issuances and capital expenditures of all principal users, owners, or related parties operate together to greatly limit the amount that may be bond financed.

C. Prior Issues Taken into Account - Same Municipality or County

The aggregation rules operate generally to limit use of small issue bonds for small facilities. In the simplest situation, small issue bonds cannot be piggybacked by the same owners or users to fund a single facility. For example, Corporation X, the sole owner and user of a facility in City Y, cannot use multiple issuances of small issue bonds to fund a single facility to the extent that combined issues exceed the aggregation limitation. This is clearly within the language of the statute since the prior issues would apply to the same principal user in the same locality.

The scenarios become increasingly complex as the concept of "same locality" or "principal user" expand. Under the statute, location of the facilities is determined by reference to the "same incorporated municipality" or "same county." If Corporation X owns several facilities throughout a city, and small issue bonds are used to fund any of the other facilities, the outstanding face amount of the bonds must be aggregated. Thus, a principal owner/user cannot spread various departments of a single operation throughout a community to increase its tax exempt bond financing.

D. Integrated or Contiguous Facilities

Both of the scenarios described above involved the same municipality and the same sole user. But what happens when either or both of the variables change? The Service expanded the concept of "same locality" slightly to include facilities beyond the same incorporated municipality or same county. Under limited conditions, facilities that are integrated with or contiguous to other bond financed facilities may be aggregated. Such provisions prevent businesses from avoiding the aggregation requirements by dividing its operations among several facilities and locating those facilities in adjoining jurisdictions.

The same rules concerning integrated or contiguous facilities also apply to capital expenditures. In fact, most of the Service's published materials address capital expenditures of integrated or contiguous facilities. Nonetheless, definitions of contiguous and integrated facilities apply to either aggregation of prior issues or capital expenditures.

Section 1.103-10(d) specifies that contiguous or integrated facilities located on both sides of a border between two or more political jurisdictions shall be treated as if it is entirely within each such political jurisdiction. Rules for contiguous or integrated facilities are through two separate tests. If facilities are contiguous, prior issues are aggregated without consideration of the relationship of the facilities. The facilities may be wholly independent and unrelated. Nevertheless, prior issues are aggregated. On the other hand, integration requires aggregation of facilities if they are functionally related and within the same proximity. Generally, same proximity means one-half mile and functionally related means interdependent operations. For example, the production of yarn for use at a related carpet manufacturer was considered to be interdependent.

E. Principal Users

In the previous examples, the bonds were issued to a single principal user. However, small issue bonds are further limited by defining principal user as a person who is a principal owner, principal lessee, principal output purchaser or other principal user. Use of the article "a" is significant because it means there can be multiple principal users of a facility. Although no regulation or statute defines "principal user," the Service has consistently applied a 10 percent test, in which a principal owner or user has a greater than 10 percent interest in the facility. Thus, a single facility can have multiple owners, lessees, sublessees and so forth. In terms of aggregation of prior issuances, any small issue bonds issued to any principal user will be aggregated. More importantly, with respect to the $5/10 million election, capital expenditures of all principal users will be aggregated. This expansive definition operates to ensure that principal owners or users cannot combine small issues to increase the amount of tax-exempt financing. Thus, aggregation rules limit the combination of small issues to fund larger facilities than contemplated by the statute.

Note, however, in one private letter ruling, a purchaser of 39 percent of the production was not regarded as a principal user when the surrounding facts and circumstances demonstrated a lack of ownership control. This conclusion was reached notwithstanding Prop. Reg. § 1.103-10(h)(1)(iii) that provides that a purchaser of 10 percent of a facility's output is a principal user.

F. Condominiums

Interestingly, in this one area, the Service permitted the combination of small issue bonds to fund a single building or factory. In G.C.M. 38402 (June 5, 1980), the Service concluded that 12 separate series of industrial development bonds qualify as small issue bonds. Citing Rev. Rul. 74-380, 1974-2 C.B. 32 (later revoked by Rev. Rul. 81-216, 1981-2 C.B. 21), the G.C.M. concluded that each separate series is a separate $1 million issue. It then concluded that each issue would not be aggregated with the other issues. It reasoned that aggregation applied only with respect to the user and not the facility. Since the users of each floor of the facility are unrelated, the prior issuances would not be aggregated. Using this 1980 G.C.M., several private letter rulings allowed condominium financing with small issue bonds in the following few years. This method of bypassing aggregation requirements was the subject of legislation in 1984.

The Deficit Reduction Act of 1984, P.L. 98-369, added I.R.C. § 103(b)(6)(P) renumbered as I.R.C. § 144(a)(9) in 1986 (hereinafter referred to as DEFRA without citation). This is the "anti condominium" section. It provides that multiple issues used with respect to a single building, an enclosed shopping mall, or strip of offices, or warehouses using substantial common facilities shall be treated as a single issue. In the *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong. 2nd Sess. (Joint Comm. Print 1984), the Joint Committee on Taxation states that the purpose of the provision is to prevent avoidance of the limitations on small issue bonds by dividing ownership of a project among several persons. Furthermore, any principal user of any of the financed facilities would be considered a principal user of the single facility. The Joint Committee's explanation points out that common facilities may include cooling and heating facilities, or common entrances, plazas, lobbies, elevators or parking facilities.

FSA 1999-813 addresses aggregation of four individual components of a hotel, each individually owned by a separate limited partnership. This FSA addressed a fact pattern that pre-dated the DEFRA anti-condominium provision. Citing the Joint Committee Explanation, the Service acknowledged that prior to DEFRA a single facility could be divided into nominally separate facilities. The FSA addresses only prior law and warns that aggregation under pre-DEFRA standards is a difficult position at best.

Rev. Rul. 81-216 clarified that pooled arrangements would be aggregated if (1) the obligations are sold at substantially the same time, (2) the obligations are sold pursuant to a common plan of marketing, (3) the obligations will be sold at substantially the same rate of interest, and (4) a common or pooled security.

This ruling was severely limited by the Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter referred as TEFRA without citation), P.L. 97-248, I.R.C. § 103(b)(6)(K) and (L) renumbered as I.R.C. § 144(a)(6). This section provides that pooled arrangements that would otherwise be treated as a single issue will be treated as separate issues unless the proceeds are used with respect to two or more separate facilities which (1) are located in more than one state, or (2) have or will have the same principal user or related persons. For purposes of this section, principal user included franchiser. The Joint Committee, in its explanation of TEFRA, noted that businesses should be able to obtain cost savings of issuing small issue bonds in multiple lots. However, this cost savings was not meant to change what prior issues would be taken into account when aggregating issues.

G. Capital Expenditures

When first passed, the small issue exemption was limited to $1 million issuances. Because the Senate regarded a $1 million limitation as too low, Congress added a $5 million limit six months later. The issuer must elect to use the higher limit. At one time, this election had to be filed with the Service. Now, the election to use the higher limit does not have to be filed by the issuer, but rather, must be retained in its records.

The same basic aggregation rules applicable to $1 million issues applied to the $5 million issues. However, in addition to aggregating prior issues the $5 million election required the aggregation of capital expenditures from three years before the date of issuance and ending three years after. These same rules were retained in the Tax Reform Act of 1986, P.L. 99-514, in I.R.C § 144(a)(4). Proper determination of what entities must be included as principal users is critical with respect to entities that have made the $5 or $10 million election. Ordinarily, every entity included as a principal user will have some capital expenditures that must be aggregated.

The Service has consistently applied a 10 percent rule in determining a principal user. This is a facts and circumstances determination which may require use of a tape measure or calendar as well as books and records.

In addition, capital expenditures made with respect to the bond-financed project by persons other than principal users or related persons may also be aggregated. Such capital expenditures may include capital improvements by the political subdivision or by the contractor.

Because the $5 million limitation required aggregation of capital expenditures, this would conservatively limit the size of the issue. Generally, the rules seemed to work as intended. Bonds tended to be limited to small businesses. In fact, with the exception of increasing the limit for unforeseen expenditures, Congress saw little need to make any changes in the small issue exemption for ten years following its enactment in 1968.

4. Market Activity Between 1968 and 1978

The discussion on aggregation brought out some of the important developments provided in TEFRA and DEFRA. However, the discussion must step back to the late 1960's to pick up the continuing story, demonstrating the necessity for the more substantial changes set forth in these Acts. As noted in the prior section, Congressional activity with respect to small issue bonds was rather limited following the initial enactment of the provision. Subsequent to the passage of the 1968 Acts, the bond market demonstrated strong uniform growth. Industrial development bonds grew at about the same rate as governmental bonds which was approximately 10 percent per year.

In the Revenue Act of 1978, P.L. 95-600, Congress increased the amount of the small issue election from $5 million to $10 million. It also increased capital expenditures to $20 million for facilities which have received an urban development action grant. The reason given for these changes was the decreased buying power of the dollar in the years since the provision was enacted. This seems appropriate since the buying power of the 1978 dollar was about 54 percent of the 1968 dollar. See CPI Calculator, http://minneapolisfed.org/economy/calc/cpihome.html. Congress believed that the change would return the small issue exemption to its original stature but would not affect the tax exempt market. The Senate Report, S. Rep. 95-1263, 95th Cong., 2nd Sess. (1978), and the Joint Committee on Taxation in the *General Explanation of the Revenue Act of 1978*, 95th Cong. (Joint Comm. Print), noted that the increase of the amount of the small issue election would reduce government receipts by $1 million in 1979, $3 million in 1980, and between $37 million and $45 million in 1983. The increase in the election amount was not expected to greatly affect the volume of small issue industrial development bonds. Congress did not give any indication that it considered that industrial development bonds generally or small issue bonds in particular posed any threat to the tax exempt market at this time. Nor was there any reason for Congress to expect the explosion of issuances of industrial development bonds. These bonds appeared to maintain a consistent 25 percent of tax exempt issuances.

Nonetheless, within four years Congress found it necessary to impose stringent controls on the issuance of small issue bonds to curb their dramatic growth. In the *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982,* the Joint Committee on Taxation cited unprecedented growth in the volume of small issue bonds from 1976 through 1981, while issuances of governmental bonds stagnated. Between 1976 and 1982 governmental bonds increased from $25 billion to $27 billion. This is an annual growth rate of 1 percent. If inflation is considered for this period, there was a substantial decline in the volume of governmental bonds.

On the other hand, figures provided in the General Explanations, *infra*, demonstrate that exempt activity bonds in general increased at a rate of 15 percent annually. However, this cannot compare to the dramatic increase of issuances of small issue bonds during the same period. The annual increase in the volume of small issue bonds was an amazing 50 percent per year. In 1976, small issue bonds accounted for $1.4 billion or 4 percent of the total amount of tax exempt issuances. In 1981, $10.5 billion in small issue bond issuances accounted for one-fifth of the total tax exempt market. All industrial development bonds accounted for nearly one-half of all tax exempt bonds. In another two years, the Staff of the Senate Committee on Finance, 98th Cong., 2nd Sess., *Explanation of Provisions of the Deficit Reduction Act of 1984 Approved by the Committee* (Comm. Print 1984), noted that by 1983, industrial development bonds accounted for 68 percent of the total tax exempt issuances. See also the Joint Committee's General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, *supra*. Projections cited by the Joint Committee placed the volume of small issue bonds alone in excess of $31 billion by 1987.

As a result of these increases, the Joint Committee noted that industrial development bonds affected the cost of governmental bonds for public projects such as roads and schools. In effect, industrial development bonds were again eroding the benefit for tax exempt governmental financing. They noted further, that historically the advantage of tax exempt interest rates equaled about 70 percent of taxable rates. By the early 1980s, the advantage eroded to the point where tax exempt rates were about 85 percent of taxable rates. Thus, the bond market was facing a similar problem that occurred prior to the passage of the Tax Adjustment Act of 1968. The increase in industrial development issuances also resulted in a loss to the Treasury. The Joint Committee noted in 1982 that the revenue loss to the United States from small issue bonds was $1.7 billion in 1981 and was projected to be $3 billion by 1983.

5. Legislative Response - the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

Congress was concerned that (1) small issue bonds were being used to finance inappropriate business activities that did not target economically depressed areas, (2) small issue bonds were being used by large businesses, and (3) the volume of small issue industrial development bonds was eroding the tax benefit for governmental bonds.

With respect to the first concern, Congress dramatically curtailed or eliminated the use of small issue bonds to fund certain specified businesses. TEFRA provided that bonds would not be tax exempt if 25 percent or more of the bonds are used to fund certain retail activities including automobiles sales and service, retail food and beverage sales (other than grocery stores), or provision of recreation and entertainment. Furthermore, bonds would not be tax exempt if any part were used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility, racquet sports facility, hot tub facility, suntan facility, or racetrack. These restrictions are now codified in I.R.C. § 144(a)(8).

Seemingly, the funding of the specified retail, entertainment and sports activities would not provide industrial development for economically depressed areas. In effect, the use of small issue bonds may have become removed from its original intent. These restrictions, which became effective December 31, 1982, may have helped refocus use of small issue financing.

The Joint Committee noted that Congress was not sure what to do about the latter two concerns listed above. It considered several alternatives to control the issuing of small issue bonds. However, it felt ill equipped to propose a viable solution due to the absence of comprehensive and reliable information regarding the use of small issue bonds.

To address these concerns, Congress passed legislation to delay making a final decision while it acquired the necessary information. First, TEFRA terminated the exemption for all small issue bonds after December 31, 1986. As will be discussed, DEFRA amended the termination provision so that it applied to small issue bonds other than those funding manufacturing facilities. The Joint Committee noted that by this action Congress did not intend to preclude further consideration of the small issue exemption. In addition, Congress placed reporting requirements on issuers. With the necessary information, Congress would be able to make a comprehensive review of small issue bonds.

A. Other Changes to Control Growth of Small Issue Bonds

Prior to TEFRA, business could finance the purchase of assets and then depreciate the assets with an accelerated cost recovery system. Congress believed that the combined subsidies provided too much of a benefit. The Joint Committee, without giving reasons, noted that Congress believed that removal of an accelerated cost recovery system (ACRS) subsidy would decrease the total subsidy but would not cause a reduction of the use of small issue bonds in appropriate circumstances. Under the new rules, property financed with small issue bonds had to use a straight line method of recovery. TEFRA retained the dual subsidy for certain worthy activities, including low income housing, solid waste disposal, pollution control and public sewage. The dual subsidy was later eliminated entirely. See discussion in footnote 1 on ACRS, *infra*.

B. Limitation on Investments

To prevent industrial development bond proceeds from being issued primarily for investment purposes, Congress included a provision to establish that the average length of maturity of the bond could not exceed 120 percent of the average estimate useful life of the assets financed with the proceeds of the bonds.

C. Public Approval

TEFRA also added a hearing and public approval requirement for all private activity bonds, not just small issue bonds. By making small issue bonds subject to a public approval process, Congress made them more responsive to the community. This helped refocus the use of these bonds for the public benefit.

6. The Deficit Reduction Act of 1984 (DEFRA)

The Joint Committee in its General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, *supra,* noted "[t]he TEFRA limitations on private activity bonds including public notice and approval requirements, information reporting requirements, the limitations on cost recovery, and the limitations on small issue IDBs restricted the benefits associated with certain IDB-financed projects and eliminated some of the abuses associated with private activity bonds. However, Congress determined that the TEFRA rules appeared unlikely to impose adequate limits on the overall growth in the volume of private activity bonds." The Joint Committee noted that the volume of private activity bonds had grown from $6.2 billion in 1976 to $62.4 billion in 1984.

Congress' focus to limit the volume of all private activity bonds provided additional controls applicable to small issue bonds. Part of their approach was to set a cap on the volume of private activity bonds each state could issue. The volume limit under DEFRA was the greater of $150 for every resident of the state or $200 million per state. Certain private activity bonds were excluded because they were, in effect, governmental functions. Nonetheless, this volume cap did several things. First, it effectively limited the total volume of private activity issuances. Not counting the exceptions, issuances under this volume cap would roughly be two-thirds the 1984 level of $62.4 billion. Second, a state's volume limitation was allocated among issuing authorities within a state. Thus, any single issuing authority might not have capacity to fund substantial projects. Third, and probably most importantly, a state's issuing authorities had to select among competing applications for bond funding. Generally, projects providing greater public benefit would tend to be favored. This seems particularly true since TEFRA required private activity bonds to obtain public approval. Thus, small issue bonds would require some level of public backing.

The volume cap under DEFRA, refocused the use of small issue bonds on the economic development of poor rural areas. Public approval for a particular business activity may not get as much support in a developed area which may have plenty of economic opportunity as it would in a rural underdeveloped area. Thus, it appears that the volume cap operated to limit the scope of small issue funding and influence the type of projects funded. These considerations were even more pronounced with the volume cap under the Tax Reform Act of 1986, P.L. 99-514. It substantially decreased the total available volume cap. Although states with lower populations benefitted slightly, the decrease in the per capita limitation from $150 to $75 severely limited the overall available caps. Nationwide, the available volume for private activity bonds decreased to about $20 billion annually. This limitation may ultimately prove to be the most significant control of small issue bonds.

DEFRA limited the amount of industrial development bonds a beneficiary may receive to $40 million. This limitation, still in effect, applies to any test-period beneficiary, i.e., owner or principal user of the facility being financed. The test period extends three years from the later of date of issue or the date the facility was placed in service. If the limit is exceeded at any time during the test period, the small issue bonds are taxable from the date of issue. This provision applies to all outstanding industrial development bonds that a test-period beneficiary may have nationally during the test period. So, a person cannot use small issue bonds to fund an owner's national chain.

As already discussed, DEFRA limited the scope of a particular project by prohibiting the use of multiple issues to otherwise unrelated persons to fund a single facility. Thus, DEFRA eliminated the common practice of dividing a single project into condominium units with each unit being financed with small issue bonds.

DEFRA eliminated dual subsidies with respect to private activity bonds in two areas. First, it completed the approach started by TEFRA concerning ACRS deductions. TEFRA had eliminated ACRS generally for tax exempt bond financed projects. However, TEFRA provided several exceptions. First, a taxpayer could use accelerated cost recovery if it elected to use a longer recovery period than provided in ACRS. TEFRA also allowed accelerated recovery for multifamily housing, sewage and solid waste disposal facilities, water and air pollution control facilities, and UDAG-funded projects. DEFRA eliminated this dual subsidy for everything except multifamily housing. Two years later the Tax Reform Act of 1986, P.L. 99-514, I.R.C. § 168(g) excluded qualified residential rental property from the definition of tax exempt bond financed property. Thus, this property was treated as ordinary residential property having a recovery period of 27.5 years.[1]

Second, DEFRA eliminated tax exemption on interest on obligations issued with a federal guarantee. Elimination of dual subsidies would not, in themselves, control issuance of private activity bonds generally or small issue bonds in particular. Yet, this provided one more factor to make them less attractive.

Also, DEFRA made industrial development bonds less attractive to investors by extending rebate requirements applicable to such bonds. Arbitrage earned on nonpurpose investment of proceeds of industrial development bonds must be rebated to the United States.

[1] In stages, TEFRA, DEFRA, and the Tax Reform Act of 1986 eliminated the dual subsidy of allowing tax exempt bond financed facilities to use an accelerated cost recovery form of depreciation deduction. Not all conduit borrowers are aware of the prohibition against using accelerated cost recovery. In the recently completed Small Issue Bonds Compliance Initiative, the largest single reason for changed cases with respect to returns of new money issuances resulted from use of accelerated cost recovery. The rate of noncompliance concerning depreciation of bond financed property was about 25 percent of the new money issuances. This study certainly supports the discussion in the Tax Exempt Bonds Phase I Training Text which states that review of depreciation schedules is a key area of an examination of small issue bonds.

Conduit borrowers must use an alternative straight line method set forth as follows: Pursuant to I.R.C. § 168(g)(1), the depreciation deduction for tax exempt financed property provided under I.R.C. § 167(a) shall be determined under the alternative depreciation system under I.R.C. § 168(g)(2) applicable to tax exempt financed property. This is a straight line method using the applicable convention of I.R.C. § 168(d) and the recovery period specified in I.R.C. § 168(g)(2) using class life specified in I.R.C. §§ 168(g)(3) and 168(e)(3). The recovery periods for the alternative depreciation system are longer than the generally applied recovery periods set forth in I.R.C. § 168 (c) except for qualified residential rental projects. Such property is excluded from the definition of tax exempt bond financed property under I.R.C. § 168 (g). Accordingly, it uses the 27.5 year recovery period for residential rental property under I.R.C. § 168(c).

Part of the purpose of TEFRA in 1982 and then DEFRA in 1984 was to refocus the use of small issue bonds. Historically, small issue bonds operated to provide economic development for poor rural communities. Back in 1968 when the Treasury Department was seeking to eliminate industrial development bonds altogether, the Senate Finance Committee vigorously supported retention of a subsidy for the development of economically underdeveloped communities. DEFRA provided that interest on industrial development bonds was not tax exempt if any part of the proceeds was used to finance any airplane, skybox or other private luxury box, health club facility, gambling facility, or liquor or package store. Although this prohibition affected all industrial development bonds, it added to the list of facilities or assets small issue bonds could not finance. This is codified in I.R.C. § 147(e).

If the purpose behind TEFRA's elimination of all small issues after December 31, 1986, was, in part, to find a way to refocus the use of small issue bonds to benefit underdeveloped targeted areas, then DEFRA may have found part of the solution. In an experimental tack, the Conference Committee amended DEFRA to extend the exception for the small issue exemption for two years, through December 31, 1988. H.R. Rep. No. 98-861, 98th Cong., 2nd Sess. (1984). However, the time extension applied only to manufacturing facilities. This provision became effective December 31, 1986. As noted, TEFRA had also limited or eliminated tax exempt bond funding for various specified activities or facilities.

The effect of the three provisions taken together is a sequential reshaping of what facilities could be financed with small issue bonds. Effective after December 31, 1982, there was a severe limitation if not virtual elimination of tax exempt financing for auto sales and service, restaurants, bars, and recreational and entertainment facilities. Also, at this same time there was elimination of the small issue exemption for golf courses, country clubs, massage parlors, tennis clubs, skating facilities, racquet sports facilities, hot tub facilities, suntan facilities, or racetracks. Then, effective after December 31, 1984, any airplane, skybox or other private luxury box, health club facility, gambling facility, or liquor or package store could not be financed with industrial development bonds including small issues. Interestingly, these items can still be funded with tax exempt bonds such as 501(c)(3) bonds under I.R.C. § 145. Then with a giant step, only manufacturing facilities could be funded with small issue bonds after December 31, 1986. The extension for manufacturing facilities lasted for only two years. Thus, the final step, as set forth in TEFRA, remained the complete elimination of small issue bonds after December 31, 1988.

DEFRA limited the amount of non-agricultural land that could be bond financed. It also prohibited the acquisition of existing facilities, although it would allow acquisition of an existing facility if the bonds financed substantial rehabilitation of the facility. Again, the purpose of small issue bonds is to encourage economic development. Mere purchase of land or existing facilities does not accomplish the underlying purpose of the small issue exemption. The idea is that a new facility would create new jobs.

Although generally the purchase of land is limited to 25 percent of the proceeds of a small issue, this limitation does not apply to first-time farmers. DEFRA provides that an individual may receive proceeds of up to $250,000 to purchase farmland. In fact, notwithstanding the general 25 percent limitation, a first-time farmer may spend the entire proceeds on farmland. Note, the provision assists individuals rather than persons. This is really unrelated to the rest of the small issue provisions. It is meant to help the small family farmer, not the corporate farmer. As will be discussed, this unrelated provision ultimately helps define manufacturing.

7. Manufacturing

On December 31, 1986, TEFRA's termination of the small issue exemption took effect. However, a sunset provision applicable to manufacturing facilities was extended several times. This sunset provision was removed by the Revenue Reconciliation Act of 1993. Thus, since 1986 only manufacturing facilities (and first time farmers) could be financed with small issue bonds. Accordingly, the meaning of the term "manufacturing" has been the primary focus of those dealing with small issue bonds.

In its *General Explanation of the Deficit Reduction Act of 1984*, *supra*, the Joint Committee explains,

> [t]he term manufacturing facility generally means any facility that is used in the manufacturing or production of tangible personal property (including processing resulting in a change in the condition of such property). Congress intended that this extension generally not be construed to apply to nonmanufacturing facilities that are associated with manufacturing facilities. For example, the fact that a de minimis amount (e.g., less than five percent) of the space in a manufacturing plant is devoted to offices directly related to the manufacturing process conducted in the plant may be disregarded. However, a separate office building in a manufacturing complex or an office wing of a larger, mixed-use building would be treated as a nonmanufacturing facility.

These limitations are consistent with Congress' overall efforts to ensure that the small issue exemption operates to provide industrial development in economically depressed areas. By limiting the subsidy as described, small issue bonds will more likely provide needed employment for blue collar population in areas of underemployment. The Joint Committee indicates that Congress had no interest in subsidizing corporate offices benefitting white collar workers. For example, de minimis office space directly related to the manufacturing process would be allowed. This would include the office of a floor managers or supervisor. Under DEFRA any other office space would not be considered manufacturing. Thus, not only has Congress limited the small issue exemption to manufacturing, it has severely limited nonmanufacturing facilities that could be financed as part of a manufacturing facility.

The extent to which related functions would be included as "manufacturing" created some concern in Congress, which revisited the issue in the Technical and Miscellaneous Revenue Act of 1988, I.R.C. § 144(a), (TAMRA). TAMRA refined the definition of manufacturing to include facilities directly related and ancillary to a manufacturing facility. However, such ancillary facilities must be located on the same site and 25 percent or less of the proceeds are used to finance such facilities. The language change and clarification of the term "manufacturing" in I.R.C. § 144(a)(12)(C) did not change the application of manufacturing. In fact, in the above quotation from the Joint Committee's Explanation of DEFRA, the last sentence is restated in its Explanation of TAMRA virtually unchanged. Rather than state that a separate office building or office wing would be treated as nonmanufacturing, it states that such facilities would not be treated as functionally related and subordinate to an exempt facility. The Committee noted that the purpose of the amendment was to clarify its original intent rather than make substantive changes.

Thus, the clarification provided by TAMRA will not increase the amount of office space that can be financed with a small issue bond. However, it will allow up to 25 percent of the net proceeds to be used for ancillary and subordinate functions necessary for the manufacturing process. Facilities such as short term warehousing for inventory and raw materials, fork lifts, laboratories for quality control and other similar facilities are related and subordinate. However, general offices including accounting, payroll, etc. are not related and subordinate. Similarly, facilities that would otherwise be considered as part of the manufacturing process will not be treated as functionally related if they are too large in scope. For example, long term warehouse storage is beyond the scope of being part of the manufacturing process. In addition, any ancillary function cannot be funded with small issue bonds if it is not on the same site as the financed manufacturing facility.

In this respect, Congress distinguished core manufacturing and ancillary manufacturing activities. H.R. Rep. No. 391, 100th Cong. 1st Sess. and H.R. Rep. No. 795, 100th Cong. 2nd Sess. Note that core manufacturing is defined to include only facilities actually engaged in production. For example, fork lifts would not be included in core manufacturing even though such equipment is integral and necessary to the overall manufacturing process by moving raw materials, intermediate parts and finished products around the facility to where they are needed. Nonetheless, fork lifts do not produce anything and are not considered part of the core manufacturing process. Thus, core manufacturing is only the actual production process.

The actual production process must result in a change in the condition of the property. I.R.C. § 144(a)(12)(C) provides that manufacturing facility is any facility used in the manufacturing or production of tangible personal property (including the processing resulting in a change in the condition of such property). However, not every process resulting in a change in the condition of personal property is manufacturing.

First of all, farming, horticulture or other similar processes involving harvesting of animal or vegetable products is not manufacturing even though it involves personal property which has changed its condition. “Production of tangible personal property” implies some change actually caused by human manipulation, i.e., man-made. In agriculture, the change occurs as a natural growth process, notwithstanding the farmers manipulation of conditions to encourage that growth. Similarly, the personal property obtained by the harvesting of wild animals or vegetables does not constitute man-made products.

The Service has consistently applied this position. In 1988, the Service noted that the term manufacturing does not include feeding, growing, or harvesting. Moreover, facilities involved in such activities are agricultural and would more appropriately be included within the realm of activities funded pursuant to the first-time farmer exemption. If agricultural activities were considered to be manufacturing, then there would have been little need for the first-time farmer exemption as all farmers would otherwise be able to finance operations with small issue bonds. One supporting point from the legislative history, the Joint Committee, in its General Explanation of DEFRA, noted that bond proceeds used to finance agricultural land are not bonds used for manufacturing facilities. The Committee believed that farming was not manufacturing under DEFRA.

Second, a change in condition may be so minor it would not be regarded as manufacturing. For example, the Service ruled that reverse vending machines for recycling is not an independent manufacturing facility because there is no formation of an intermediate product. The ruling notes that the change in the condition of the product merely facilitates storage of the recyclables, so it is not manufacturing. The ruling does not address whether crushed glass available for sale to a bottle manufacturer would constitute an intermediate product.

Generally, the Service interprets the change in condition necessary to demonstrate manufacturing as a transformation into a new product. For example, paper transformed into paper bags or books is a transformation that the Service regards as manufacturing. Similarly, the transformation of curd into cheese is manufacturing. Even more subtle transformations may be regarded as manufacturing. Although the harvesting of vegetable or animal products is not manufacturing, their processing for consumption may be. The Service has held that washing, grading, and packaging of scallops or vegetables can be manufacturing. In such cases, the end result of the process is a product available for sale.

Generally, the Service and Congress use the term “manufacturing” in a restricted sense to the extent that manufacturing is limited to the actual process creating a change in the property. This is core manufacturing. On the other hand, the variety of processes that may constitute core manufacturing is treated more expansively. In this respect printing of books or packaging of vegetables is considered manufacturing.

8. Conclusion

Throughout a period of about seventy years industrial development bonds have assisted underdeveloped communities attract small business. This had been the original intent of industrial development bonds as they existed prior to the 1950s in private rulings. Congress believed that this type of economic subsidy was worthwhile, so it retained the subsidy at a time when the future of industrial development bonds was threatened. Since the initial legislation providing for small issue bonds first appeared there has been a tension between attempts to expand the subsidy and efforts to retain the subsidy solely for its original purpose of helping economically underdeveloped areas. From 1968 through 1988, small issue bonds were marred with false starts, re-evaluation and regular tinkering. However, after 1988, small issue provisions stabilized. Congressional activity with respect to small issue bonds has been very limited. Service published interpretations have been virtually nonexistent since 1985. And in the last few years private letter rulings, field service advice memoranda, and technical advice memoranda relating to small issues have been limited to a few each year. While all of this indicates the law in the area is not changing as fast as it once had, it is not totally settled either. As indicated by the Qualified Small Issue Bonds Compliance Initiative implemented by the Service over the last couple years, there is substantial noncompliance in the area of small issue bonds, particularly with respect to conduit borrowers using ACRS depreciation methods or exceeding the aggregate $10 million or $40 million caps.
For information on the results of the Qualified Small Issue Bonds Compliance Initiative see *Continued Professional Education Tax Exempt Bonds Technical Instruction Program for FY 2002* at 31.